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Lessons from a Collapse of a Financial System

Sigridur Benediktsdottir

Jon Danielsson

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Sigridur Benediktsdottir, Jon Danielsson, Gylfi Zoega

Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation

Summary

The paper draws lessons from the collapse of Iceland's banking system in October 2008. The rapid expansion of the banking system following its privatization in the early 2000s is explained, as well as the inherent fragility due to the size of the banking system relative to the domestic economy and the central bank's reserves, market manipulation enabling bank capital to expand rapidly and the weak and understaffed public institutions. Most of Iceland's banking system was traditionally in state hands but was privatized and sold to politically favoured entities at the turn of the century, with laws and regulations subsequently changed to facilitate the expansion of the banking system. Political connections and the tacit support of the authorities enabled senior bank managers and key shareholders to extract significant private benefits while shifting risk to domestic and foreign taxpayers and foreign creditors. These problems were exacerbated by symptoms of what the paper terms the small country syndrome. The size of the banking sector made the central bank incapable of serving as the lender of last resort. The domestic supervisor, the central bank and the ministries in charge of economic affairs were understaffed and lacking in experience in how to manage a large financial sector. The rapid growth was also ultimately unsustainable due to high levels of leverage and a weak capital base due to both the rapid expansion of balance sheets and lending to finance investment in own shares. The episode demonstrates the importance of closely monitoring rapidly growing financial institutions and even possibly slowing growth when institutions are systemically important. One lesson to be drawn from the crisis relates to the role of politics in a financial crisis. The Icelandic authorities as a matter of policy encouraged the creation of an international banking centre. This involved the privatization and deregulation of the banking system, rules and regulations being relaxed and the neglect of financial supervision. Another lesson is that floating exchange rates can be hazardous in the presence of large capital flows. The central bank raised interest rates during the boom years in order to meet an inflation target. This created an interest rate differential with other countries that encourages a large volume of carry trades and incentivized domestic agents to borrow in foreign currency. Both conspired to create an asset price bubble, excessive currency appreciation and – counter-intuitively – high inflation. The result was that monetary policy as conducted was ineffective at curbing domestic demand. The eventual large depreciation of the currency made a large section of the economy insolvent. Finally, there are lessons about the European passport system in financial services and the common market. The Icelandic banks had the right to set up branches in the European Union by means of the passport on the explicit assumption that home regulators were exercising adequate controls. The collapse of the banks left the United Kingdom and the Netherlands with significant costs, demonstrating the inherent weakness in the passport when one member country can undercut the supervisory standards of other member countries. For the passport system to work, the home supervisor must be trustworthy.

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